DOCKET SECTION

BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D.C. 20268-0001

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POSTAL RATE COMMISSION
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Postal Rate and Fee Changes, 1997) Docket No. R97-1

OFFICE OF THE CONSUMER ADVOCATE
FILING OF CASE-IN-CHIEF
(December 30, 1997)

Pursuant to P.O. Ruling R97-1/55, setting forth the revised procedural schedule in this case, the Office of the Consumer Advocate ("OCA") hereby submits its case-in-chief, along with a summary of its direct testimony. OCA's direct case consists of the testimony of witnesses Pamela A. Thompson (OCA-T-100), John O'Bannon (OCA-T-200), Dr. Roger A. Sherman (OCA-T-300), Gail Willette (OCA-T-400), James F. Callow (OCA-T-500), Dr. J. Edward Smith (OCA-T-600), and Sheryda C. Collins (OCA-T-700). The summaries follow immediately below.

OCA-T-100. Pamela A. Thompson, a Postal Rate and Classification Specialist, updates the Commission's cost model to reflect Postal Service costing methodology changes, then uses it to replicate the Postal Service's Base Year (FY1996); FY1997; and FY 1998 (the Test Year) data. Her testimony also provides the commands for executing the updated model, and provides intervenors a personal computer based cost model that may be used to replicate Postal Service costs and run alternative cost allocations, if they wish to do so.

OCA-T-200. John O'Bannon, an economist and doctoral candidate, examines Postal Service witness Mayes' testimony regarding Parcel Post, particularly concerning volume changes in particular rate cells in the test year that would prevail after the requested rate change. He shows that for some subsets of Parcel Post, witness Mayes' estimated volume changes in certain rate cells imply positive implicit own-price elasticities, producing the economic anomaly that increasing the rate for a particular cell of service spurs an increase in volume for that cell of service. This is true for almost all the cells in the DBMC category of service and results from the fact that the Postal Service believes the overall volume will increase for DMBC despite the fact that all but two cells experience rate increases. This computational result challenges universally accepted economic theory. Under typical assumptions, positive implicit own-price elasticities are a theoretical and empirical impossibility. Mr. O'Bannon demonstrates that the current method of allocating volume estimates to different rate cells within a category of mail is causing this problem. His result does not imply that positive own-price elasticities cannot occur for cells within categories of Parcel Post, but only that the particular positive own-price elasticities used in the case of DBMC Parcel Post are not theoretically supportable by the accompanying data, meaning that some step in the Postal Service's process of allocating volume estimates to rate cells is flawed.

OCA-T-300. Dr. Roger Sherman, an economist, examines Ramsey prices. He identifies their economic welfare advantages over the prices proposed by the Postal Service, and discusses the role of Ramsey pricing for worksharing discounts. He also discusses costing principles, and the proposed reply mail services.

Ramsey Pricing: He first describes Ramsey prices and why they are superior to other pricing rules (marginal cost pricing produces deficits, and pricing above marginal costs causes welfare losses). One can avoid large differences between price and marginal cost because the welfare loss rises with the square of the price difference. But because the purpose of a rise in price is to make a contribution to fixed cost, a greater contribution should justify a greater difference between price and marginal cost. Ramsey prices balance these two considerations, making the marginal welfare loss per unit of marginal contribution equal across all services.

He then discusses the cost, demand, and demand elasticity data needed to estimate Ramsey prices. Costs and demand functions estimated by the Postal Service can be used to estimate Ramsey prices. Such prices are presented by witness Bernstein, but Dr. Sherman differs in his approach by using long-run (instead of short-run) elasticities to forecast volume responses. This affects the contribution that will be raised to cover other costs. Use of a longer-run elasticity is advisable because the prices that are adopted should be in place beyond the period of the test year.

Dr. Sherman presents a summary of Ramsey prices and their effects, and compares this with Postal Service proposals at the level of five major mail classes. Relative to Ramsey prices, the proposed Postal Service rates impose large welfare losses in First Class, Standard A, and Express Mail, and the overall welfare loss is greater under the Postal Service's proposed rates by more than $1 billion. He then explores Ramsey prices under different constraints (such as RFRA), and presents such constrained prices and their effects for the main subclasses of mail, comparing them with Postal Service proposals. He shows that total welfare loss increases every time more constraints force prices farther from their pure Ramsey levels, with the difference in welfare loss between pure and most constrained Ramsey prices amounting to $300 million. Unconstrained Ramsey prices cause a total welfare loss of $1.866 billion, while the most constrained Ramsey prices impose a total welfare loss of $2.166 billion. However, the prices proposed by Postal Service impose a welfare loss of $3.159 billion, or about $1 billion more than the most constrained Ramsey prices.

Worksharing Discounts. After defining worksharing discounts, Dr. Sherman states such discounts compare to "access" charges that allow one supplier of a service to use the resources of another supplier (e.g., one railroad uses another railroad's tracks). The "efficient components pricing" (ECP) principle of access pricing calls for the resource owner to be compensated for its own cost, including opportunity cost (such as lost profits), when granting access to others, thus motivating the resource owner to allow access and inviting low cost suppliers to participate in supplying the service. However, ECP assumes that volume shifts will be made abruptly. But when cross elasticities are not infinitely elastic at the crucial access price, then the cross elasticities should be taken into account in setting optimal prices. A ready-made means of doing so exists in Ramsey prices. The Postal Service had examined this possibility by treating worksharing as another service, applying Ramsey principles in choosing prices to maximize welfare. Several problems complicate the estimation of Ramsey prices using information presently available. The wide range of mail pieces in the two mail streams complicates cost estimation for single-piece and worksharing letters. Another problem arises in the use of demand elasticity and cross elasticity information for the calculation of Ramsey prices. Dr. Sherman concludes that other formulations may be important to examine. One could focus on the single-piece letter price as determinant of the total volume of letter mail. The discount from that price for worksharing would invite some fraction of that letter mail volume to become worksharing letters. The relevant discount elasticity would then be a supply elasticity, a willingness of mailers to provide worksharing effort in response to changes in the discount. With this formulation, there would be no need for a single-piece letters discount elasticity. Nor would there be any role for an own-price elasticity of demand for worksharing letters. The volume of letters would depend on the price of letters and other factors, including the prices of other services that had nonzero cross elasticities with letters, but not on the level of the discount. By focusing on the demand for letter mail, together with the supply of worksharing, the problem can be formulated more simply and solved more effectively.

Cost Basis for Pricing. Dr. Sherman examines the Postal Service's estimation of volume variable and incremental cost. These cost concepts permit a better representation of marginal cost for pricing purposes, and should better equip the Service to avoid cross subsidy across mail services, but redesigning the accounting procedures may produce more reliable estimates. Little attention is now given to imputation of fixed costs when they are caused by more than one service; shared costs deserve careful analysis and explanation (e.g., Bulk Mail Centers' processing of different mail classes) to help determine the level at which cross-subsidy tests should be carried out. In some cases, incremental costs should be estimated for combinations of classes, and then tests for cross subsidy should be conducted for that combination of classes. The present effort focuses on incremental cost estimates for one class at a time. It may be that when fixed costs that are shared by services are imputed to those services, a larger portion of total costs would be seen as incremental, and more incremental cost tests could be conducted.

Prepaid Reply Mail ("PRM") and Qualified Business Reply Mail ("QBRM"). Because these proposals make mailing a reply card or letter seem free to the customer, some customers may choose reply mail even though they would not do so if they faced its full cost. Thus, the final outcome may not be optimal for society. Allowing reply mailers to choose whether to mail a courtesy reply envelope at a *reduced* rate under CEM seems feasible, however, and its efficiency benefits are clearly desirable.

<u>OCA-T-400</u>. Gail Willette, an economist and Director of the Office of the Consumer Advocate, presents testimony on the feasibility of Courtesy Envelope Mail, or CEM. CEM is defined as preprinted, self-addressed envelopes that meet certain qualifications and are provided by businesses as a courtesy to their customers. In order to qualify for the CEM rate, CEM mail must: bear a facing identification mark; bear a proper barcode; bear a proper ZIP code; bear indicia signifying that the piece is eligible for the discount; meet automation compatibility standards as prescribed by the Postal Service; and be preapproved by the Postal Service. CEM mail would receive the same discount proposed by the Postal Service for QBRM and PRM because the cost avoidance of CEM and PRM/QBRM letters is the same. However, CEM would not have the additional fees associated with PRM and QBRM.

Many businesses now provide courtesy reply mail, or CRM, envelopes to their customers, that meet the CEM "clean mail" qualifications set forth above. CRM will be transformed into CEM mail with only one minor alteration, the addition of a CEM indicator on the envelope informing consumers they may use a discounted CEM stamp. The Postal Service should have no problem educating providers about new CEM requirements, and ensuring that CEM mailpieces are automation compatible. The Postal Service also can educate consumers in the same way it informs them about basic single-piece First-Class postage requirements, and variations thereof.

Witness Willette projects that nearly all CEM volume would come from CRM mailers. At a maximum, revenue loss from CEM would amount to the difference between the proposed First-Class single-piece and CEM rate (three cents per piece) times the CRM volume, or about $219 million. This is a maximum figure because perhaps half of all households would purchase a discounted CEM stamp. The CEM proposal enhances the Postal Service's PRM and QBRM proposals by giving providers a third, lower cost choice, one in which they can gain good will with customers by giving their customers the opportunity to use discounted CEM stamps. CEM will not only advance the Postal Service's stated objectives in this case but will do so in a way vastly superior to that of PRM. CEM addresses the threat of electronic diversion by providing consumers a convenient, but less expensive way to return bill payments by mail. CEM also encourages the use of automation-compatible mail. CEM further is operationally feasible because CRM providers who now enjoy a prebarcode discount will have to do almost nothing to comply with CEM regulations. In comparison, compliance with PRM will be more complicated and costly.

CEM also is consistent with statutory goals. Among other things, CEM more closely aligns rates with costs, thus promoting equity and fairness. CEM would be a classification with an extremely high degree of reliability and speed of delivery because

CEM mail is "clean" mail. While the Postal Service has long objected to CEM on such bases as the "two-stamp" problem, the Commission dismissed such operational objections to CEM in Docket No. MC95-1. In contrast, PRM likely will not attract many providers because of its high costs to them, and the policy and statutory goals ascribed to it will not be reached. The only empirical evidence shows that surveyed CRM users largely had negative feelings about PRM.

OCA-T-500. James F. Callow, a postal rate and classification specialist, addresses the Postal Service's post office box fee proposals. He proposes to restructure Fee Groups C and D into six new fee groups based upon the Cost Ascertainment Group (CAG) of post offices to create more rent-homogeneous groupings, as part of a transition to a further restructuring of these fee groups. His proposed fees reflect a new cost allocation methodology that distributes a substantial portion of volume-variable post office box costs by CAG. His proposed box fees in new fee groups CAG H-L are generally lower than under the Postal Service proposal, because their allocated costs are lower. Correspondingly, box fees are higher in other fee groups where allocated costs are higher. Witness Callow points out that average postal rental costs are higher in larger post offices, because larger post offices tend to be located in higher-rent urban areas. Also, larger (higher CAG) post offices tend to have more mailhandlers (and proportionately more costs) than lower CAG offices. Similarly, there are virtually no supervisors in offices CAG H or below. Further, postmaster salaries and benefits are higher than average for higher CAG offices.

OCA-T-600. Dr. J. Edward Smith, Jr., an economist, presents testimony commenting on the appropriateness, usefulness, and applicability of Postal Service witness Bradley's proposed cost/volume methodology (USPS-T-14). Dr. Smith believes that witness Bradley's economic framework is incomplete in terms of its explanation and justification of his cost equations and his failure to base his analysis on a production function. Nor is there adequate consideration of capital, technological change, and time trends. Dr. Smith also states that witness Bradley focuses incorrectly on short run costs, without considering the longer term during which the proposed rates will be in effect. In addition, witness Bradley's study improperly omits considerations of equipment characteristics such as capital investment, equipment age and layout.

Commenting on witness Bradley's use of a fixed effects model, Dr. Smith believes that a pooled effects approach is more consistent with the underlying form of the data and the time period over which the rates will be in effect. Dr. Smith is of the opinion that witness Bradley's analysis needs to incorporate additional variables to provide an improved understanding of cost drivers. Additional review of the data scrubbing process is needed, as is substantiation of the applicability of his conclusions based on MODS data as related to non-MODS facilities. Dr. Smith observes that a simple plotting of the scrubbed data is a variance with witness Bradley's conclusions. Dr. Smith states that witness Bradley's approach fails to meet generally accepted regulatory standards. Dr. Smith concludes that witness Bradley's study needs additional work and that implementation of the study in its current form would be premature.

OCA-T-700. Sheryda C. Collins, a postal rate and classification analyst, presents an alternative to the Postal Service's proposed rates for Standard B Library Rate mail. Because Library Rate is a low volume subclass, the small number of IOCS tallies related to Library Rate and from which the Library Rate costs are derived is an extremely thin sample and probably does not provide truly representative cost estimates of the subclass. Use of the reported attributable costs of Library Rate mail produces unacceptably high rates -- the subclass with a presumptive rate preference ends up with rates higher than the regular subclass. She proposes that the Commission use the costs of the Standard B Special Rate subclass as a proxy for the costs calculated for Library Rate. Not substituting Special Rate costs for Library Rate creates a *de facto* merger of the two subclasses, improperly eliminating by administrative fiat a preferred rate category created by Congress.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the rules of practice.

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Washington, D.C. 20268-0001
December 30, 1997